IT 02-0002-PLR 08/16/2002 BUSINESS INCOME

Private Letter Ruling: Gain on sale of business assets is business income when proceeds are used to pay off creditors and to support business of foreign affiliates.

August 16, 2002

Dear:

This is in response to your letter dated August 1, 2002, in which you request a Private Letter Ruling on behalf of COMPANY1 and its unitary affiliates (referred to collectively hereinafter as "Taxpayer"). Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to Taxpayer for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that Taxpayer and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

Taxpayer is seeking a ruling that the gains expected to be recognized in the proposed transaction, described below, will constitute business income under the Illinois Income Tax Act.

BACKGROUND

COMPANY1 is a Delaware corporation that files a single Illinois income tax return on behalf of itself and its unitary affiliates (referred to collectively hereinafter as "Taxpayer"). Taxpayer operates primarily through COMPANY1's wholly-owned subsidiary, COMPANY2. Taxpayer is engaged in business in many states and in numerous foreign countries. In addition, independent franchisees of Taxpayer operate in a number of states and in several foreign countries. On July 29, 2002, COMPANY1 and most of its affiliates, including COMPANY2, filed a petition for relief under Chapter 11 of the United States Bankruptcy Code.

Taxpayer believes that it is likely that it will sell substantially all of its assets (including the stock of certain subsidiaries) to a single buyer that is unrelated to Taxpayer. It is expected that most of the gain from the transaction will be attributable to the sale of Taxpayer' s business intangibles—*i.e.*, its goodwill and the primary trademarks and trade names under which it operates its business. The sale is expected to close prior to the end of 2002.

The consideration for the sale will be the payment of some cash with the balance in the form of the buyer's assumption of trade payables, employee benefit obligations, bank indebtedness and certain other liabilities. It is expected that the total consideration for the transaction will be insufficient to pay all of the Taxpayer's creditors; thus, no proceeds of any kind will be available for distribution to shareholders.

At this time it is contemplated that Taxpayer will not include in this sale the assets of certain of its foreign subsidiaries. Those operations represent approximately 5–10% of Taxpayer's business. Taxpayer will continue to operate those businesses until it can find a purchaser. Some of the cash proceeds from the larger sale may be required to maintain the foreign operations until a purchaser can be found. It is expected that any proceeds from the disposition of the foreign businesses will be required to repay creditors, and will *not* be available for distribution to shareholders.

RULING REQUESTED

Taxpayer respectfully requests that the Department rule that gain arising from the disposition of all of Taxpayer's assets, where the proceeds from the disposition are used solely to repay creditors, constitutes business income under section 1501(a)(1) of the Illinois Income Tax Act (the "IITA," 35 ILCS 5/101, *et seq.*).

DISCUSSION [BY TAXPYAER]

Overview

The Illinois Supreme Court, in *Texaco-Cities Service Pipeline v. McGaw*, 182 Ill.2d 262, 695 N.E.2d 481 (1998), established the general rule that gain from the sale of assets constitutes apportionable business income under the so-called "functional" test if the assets had been used in the taxpayer's regular trade or business operations. Under this test, Taxpayer's expected gain from the sale of its assets would constitute business income. There is only one arguably contrary authority, *Blessing/White, Inc. v. Zehnder*, __ Ill. App. 3d __, 768 N.E.2d 332 (1st Dist. 2002). *Blessing/White,* however, can be read as contrary only to the extent that the Department takes the affirmative step of unnecessarily and inappropriately expanding the narrowly circumscribed exception to *Texaco-Cities* created by the Appellate Court.

Moreover, the general rule established in *Texaco-Cities* should be applied in this case because it is consistent with U.S. Supreme Court precedent defining business income from a constitutional perspective (*see Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992)) and will thereby protect the state from the whipsaw that would occur if different rules were applied to in-state and out-of-state companies in a broad array of transactions. The exception as expressly set forth in *Blessing/White* is sufficiently narrow to minimize this risk to the Department, which would be exacerbated in future periods because of the election for taxpayers provided by S. B. 2212 to treat all income as business income. Finally, expanding *Blessing/White* to Taxpayer's situation would raise significant constitutional concerns.

The General Rule of *Texaco-Cities*

Section 1501(a)(1) of the IITA defines "business income" to include "income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The Illinois Supreme Court in *Texaco-Cities* determined that the above-stated component of the business income definition constitutes a "functional" test for determining whether income from the disposition of capital assets constitutes business income. The court explained that the plain language of the " functional" test focused on the taxpayer's relationship to the property before the disposition. 182 Ill.2d at 272, 695 N.E.2d at 486. Under this test, the Court set forth the general rule that gain from the sale of assets that had been used in the business constitutes apportionable business income.

The Court held that the gain from Texaco-Cities' sale of approximately 90% of its pipeline assets (where the taxpayer did not distribute the proceeds of the disposition to its shareholders) constituted business income. The court rejected the taxpayer's attempt to analogize its facts to *Laurel Pipe Line v. Pennsylvania*, 537 Pa. 205, 642 A.2d 472 (1994),

involving a Pennsylvania statute nearly identical to section 1501(a)(1) of the IITA. The *Texaco-Cities* court distinguished *Laurel Pipe Line* on the ground that *Laurel Pipe Line* involved a distribution of the sale proceeds to the shareholders rather than an investment of the proceeds back into the taxpayer' s business. There is no indication in *Texaco-Cities* that the Court intended to create an exception of broad application.

The Narrow *Blessing/White* Exception

In *Blessing/White*, the Illinois Appellate Court, interpreting the dictum in *Texaco-Cities* distinguishing *Laurel Pipeline*, created a very narrow exception to the general rule that gain from assets that had been used in the business constitutes business income. In *Blessing/White*, the taxpayer sold all of its assets, ceased its operations, and distributed to its shareholders all of the sale proceeds. The *Blessing/White* court suggested that by discussing and distinguishing *Laurel Pipe Line*, *Texaco-Cities* thereby established a modified form of the " functional" test that was applicable to the disposition of assets made pursuant to a corporate liquidation the proceeds of which were distributed to the corporation's shareholders. This exception, however, is quite limited. A liquidation of assets will constitute nonbusiness income only if two independent tests are met: (i) the liquidation must not be essential to the taxpayer's regular business operations *and* (ii) all of the sale proceeds must be distributed to the corporation's shareholders. If either one of these tests is not satisfied, then gain constitutes business income under the general rule of *Texaco-Cities*.

Importantly, *Texaco-Cities*, *Blessing/White* and *Laurel Pipeline* all recognized that use of substantially all of the sale proceeds to repay existing indebtedness is a business use. Each of those cases contrasted the business income determination in the earlier Pennsylvania case of *Welded Tube Co. v. Commonwealth*, 101 Pa. Commw. 32, 515 A.2d 988 (1986), with the nonbusiness income determination in *Laurel Pipeline* on the ground that the taxpayer in *Welded Tube* reinvested the proceeds of the sale in its business. *Texaco-Cities*, 695 N.E.2d at 486–487; *Blessing/White*, 768 N.E.2d at 581 (quoting *Texaco-Cities* for this same proposition, but without *Texaco-Cities '* supporting cite to W*elded Tube*); *Laurel Pipeline*, 642 A.2d at 475. In *Welded Tube*, the taxpayer sold the real estate, machinery and equipment at its Pennsylvania manufacturing facility. The taxpayer *used over 87% of the proceeds to repay existing indebtedness* and invested the balance in its relatively new Chicago manufacturing facility. The court held that the gain was business income, stating:

> We are further persuaded in our determination by the taxpayer's subsequent use of the gain, which use, as we have noted, is a criterion in the classification of business income. . . . As the parties stipulated, $3,308,503 of the proceeds of the sale of the Philadelphia facility was used by the taxpayer to extinguish existing debts and $486,000 of the proceeds was used to expand the Chicago facility. (515 A.2d at 994.)

None of the proceeds were distributed to shareholders. Each of these cases, including *Texaco-Cities* and *Blessing/White*, recognizes that use of substantially all of the proceeds from a sale of assets to repay existing indebtedness requires that the gain from the sale be characterized as business income.

In Taxpayer's case, all of the assets to be sold have been, and are, being used by the Taxpayer in its regular business operations. Thus, gain on the disposition constitutes business income under the " functional" test as defined by the Illinois Supreme Court in *Texaco-Cities*. Even taking into account the exception set forth in *Blessing/White,* the gain will constitute business income because the disposition will be undertaken for a purpose integral to the Taxpayer's regular trade or business operations—*i.e.*, to satisfy indebtedness. Underscoring this point in Taxpayer's case is the fact that most of the "proceeds" will be in the form of assumption of liabilities rather than the payment of cash.

Moreover, Taxpayer's gain from the sale of its assets would constitute business income under *Blessing/White* because *all* of the proceeds will be distributed to creditors rather than shareholders. *Blessing/White* expressly required that the proceeds be distributed to shareholders in order to properly characterize the gain as nonbusiness income. The lack of a distribution to shareholders brings this case within the ambit of *Welded Tube* and *Texaco-Cities*—and fundamentally distinguishes it from *Blessing/White*, as well as the other cases relied upon by *Blessing/White*, *i.e., Laurel Pipe Line*; *Lenox v. Tolson*, 353 N.C. 659, 548 S.E.2d 513 (2001); and, *Kempell v. Zaino*, 2001 Ohio 92, 746 N.E.2d 1073 (2001), all of which involved the distribution of the proceeds to shareholders. Thus, the modified "functional" test applied in *Blessing/White* does not apply to Taxpayer's transaction. In the circumstances, the Department should find that gain from the expected disposition of Taxpayer's assets constitutes business income under IITA section 1501(a)(1).

The Department Should Not
Expand *Blessing/White* Beyond the
Circumstances Presented in that Case

Expanding Blessing/White would permit the Department to be whipsawed. In order to prevent, or at least minimize, the possibility that the Department would be whipsawed by in-state and out-of-state taxpayers, the Department should not expand *Blessing/White* beyond the narrow circumstances presented in that case. For tax years beginning on or after January 1, 2003, IITA section 1501(a)(1) (see S.B. 2212) will permit taxpayers to make an annual, irrevocable election to treat all income as business income. Thus, it can be assumed that any Illinois-domiciled taxpayer completely liquidating will elect to have its income taxed as business income. In contrast, no reasonable taxpayer domiciled outside Illinois will make that election.

Because there should be few instances in which a taxpayer liquidates its assets *and* distributes all of the proceeds to shareholders, confinement of *Blessing/White* to the facts of that case should not materially increase the number of transactions resulting in nonbusiness income. However, if the Department unduly expands the *Blessing/White* exception to cover any liquidation of assets without requiring that the proceeds be distributed solely to shareholders, a significantly larger class of transactions would be considered nonbusiness income and would be reported as such by out-of-state taxpayers (but not in-state taxpayers, who would make the S.B. 2212 election). Sound administration of the tax laws thus dictates that the Department not expand *Blessing/White* beyond the narrow circumstances presented in that case.

Expanding Blessing/White beyond its facts would raise significant constitutional concerns. Well-established rules of construction require that a statute be interpreted to avoid raising doubts as to its constitutionality. *E.g.*, *Thorpe v. Mahin*, 43 Ill.2d 36, 250 N.E.2d 633 (1969)

(upholding constitutionality of Illinois Income Tax Act). Expanding the narrow holding of *Blessing/White* would bring into question the constitutionality of treating income as nonbusiness income in a significant number of cases. Expanding *Blessing/White* to Taxpayer's case would be plainly unconstitutional. Taxpayer's gain from the disposition of its assets is expected to consist primarily of gains from the sale of business intangibles, *i.e.*, goodwill and the trademarks and trade names under which the multistate and multinational business is conducted; therefore, a determination that such gain constitutes nonbusiness income would require that 100 percent of that gain be allocated to Illinois under IITA section 303, rather than apportioned under IITA section 304 among the states in which Taxpayer does business, even though under *Allied-Signal* those other states would be permitted to, and will, tax their apportioned shares of the gain.

Allocation to Illinois, rather than apportionment among the states, of all of the gain from Taxpayer's disposition of its intangible assets would thus creates unconstitutional multiple taxation. *Mobil Oil Corp. v. Commissioner of Taxes* , 445 U.S. 425 (1980). In *Mobil*, the Court held that Vermont could tax an apportioned share of Mobil's dividend income that Mobil, a New York domiciliary, received from its unitary affiliates. The Court stated that "'the reason for a single place of taxation no longer obtains' when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction." *Id*. at 445. Mobil had contested the constitutionality of an apportioned Vermont tax on its dividend income on the ground that New York, Mobil's state of commercial domicile, could tax all of Mobil's dividend income without apportionment. Allowing the state of commercial domicile to tax all of the Mobil's dividend income and Vermont to tax an apportioned share of such income would subject Mobil to multiple taxation. The Court rejected Mobil's contention that New York as the state of commercial domicile could tax all of Mobil' s dividend income, stating, "These are the circumstances in which *apportionment is ordinarily the accepted method*." *Id*. (Emphasis supplied.) The Court further stated that in determining whether Mobil was subject to multiple taxation, it was necessary to determine only that New York had the authority to impose such a tax —not that New York in fact imposed the tax: "We agree with Mobil that the Constitutionality of the Vermont tax should not depend on the vagaries of New York tax policy." *Id.* at 444.

The court amplified these concerns in *Allied-Signal*. In that case, New Jersey sought to tax the gain recognized on the taxpayer's disposition of stock in a corporation with which the taxpayer was *not* engaged in a unitary business. The court reaffirmed its prior holdings that gain from the sale of a nonunitary business was nonbusiness income, and held that the purpose of the disposition was irrelevant, as long as the investment disposed of was a nonunitary business. The court further held that income or gains derived from certain capital transactions where the "payor" of the income or gains was not unitary with the recipient would nevertheless constitute business income if the capital transaction, *i.e.*, the original investment, served an operational function rather than an investment function.

There can be no doubt that Taxpayer's goodwill and operating trademarks and trade names constitute unitary assets (that by definition bear an operational connection to the business); therefore, any gain from the sale of the assets would constitute business income that the other states in which Taxpayer has conducted its business have the right to tax. The fact that the gain may arise in the context of a complete liquidation is irrelevant—under *Allied-Signal* the purpose of the disposition and the use of the proceeds is irrelevant. The only determinative fact for constitutional purposes is the use of the assets while held. Thus, assignment of the

entire gain in question to Taxpayer's Illinois commercial domicile would subject Taxpayer to significant multiple taxation. The court in *Allied-Signal* stressed that such a result would be untenable:

> Indeed, if anything would be unworkable in practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax under the unitary business principle. State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State . . . . Were we to adopt New Jersey 's theory, *we would be required either to invalidate those statutes or authorize what would be certain double taxation.* (*Id.* at 785 (emphasis supplied).)

The Court plainly assumed that the states' nonbusiness statutes were coextensive with its prior constitutional rulings on the distinction between apportionable business income and allocable nonbusiness income. Equally plain is the court's concern that any divergence between its standard and the standards under state law would raise significant constitutional issues. Taxpayer's proposed transaction gives rise to precisely the types of concerns that so troubled the Court in *Allied-Signal.*

Allocation to Illinois of Taxpayer's gain from the sale of its business intangibles would run afoul of the constitutional prohibitions set forth in *Mobil* and *Allied-Signal* that the state of commercial domicile cannot tax 100% of the gains from unitary intangible assets, but must instead apportion such gains. Although the Department cannot declare the holding in *Blessing/White* unconstitutional, it may not, under established rules of construction, expand the narrow holding of *Blessing/White* to cover the facts in this case because any such expansion would have an unconstitutional result. *Blessing/White* did not involve the constitutional issues in the present case because the Court held that Illinois could not tax *any* of the gain in question. Nothing in the Constitution requires Illinois to tax any particular income—but it does proscribe Illinois from allocating to itself income that is properly apportionable to other states.

CONCLUSION [OF TAXPAYER]

Taxpayer respectfully requests that Department rule that the gain expected to be derived when Taxpayer sells its assets and distributes all of the proceeds to its creditors rather than its shareholders constitutes business income.

REQUIRED STATEMENTS

1. The tax period at issue is the tax year ended December 31, 2002.

2. No audit or litigation regarding this tax period or the issues presented is pending with the Department.

3. To the best of the knowledge of both the Taxpayer and the undersigned, (i) the Department has not previously ruled on the same or a similar issue of the taxpayer or a predecessor and (ii) neither the Taxpayer nor any representative has previously submitted the same or a similar issue to the Department and withdrawn it before a letter ruling was issued.

4. Favorable and contrary authorities have been discussed above.

5. A Power of Attorney is attached.

6. A Deletions Statement is attached.

Ruling by Department

Section 1501(a)(1) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq*.) defines the term "business income" as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Such term does not include compensation or the deductions allocable thereto.

Section 1501(a)(14) of the IITA defines "nonbusiness income" as follows:

> The term "nonbusiness income" means all income other than business income or compensation.

The Illinois Supreme Court recently provided an in-depth discussion on the definitions listed above in Texaco-Cities Service Pipeline Company v. McGaw, 182 Ill.2d 262, 695 N.E.2d 481, 230 Ill.Dec. 991 (1998). The issue in Texaco-Cities was whether the sale of a pipeline constituted "business income". The court determined that the above statutory definition of "business income" required an analysis of two tests, the transactional test and the functional test, and that income is considered business income if one of these two tests were met. Under the transactional test, income is business income if it is "attributable to a type of business transaction in which taxpayer regularly engages". Under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was "used by the taxpayer in its regular trade or business operations".

The present factual situation calls for the analysis of the functional test. In interpreting the functional test, the Illinois Supreme Court held that the sale of property constitutes business income if the property and sale are essential to the taxpayer's business operations. Thus, the focus is on (1) the role or function of the capital asset being disposed of, and (2) whether the sale of the property is essential to the business operations.

You have represented that the property to be sold consists of business intangibles such as the business goodwill, primary trademarks and trade names under which the business is currently operating. All three business intangibles listed in your fact situation are essential for a business to continue its operations. Your statement that "all of the assets to be sold have been, and are, being used by the Taxpayer in its regular business operations" confirms that the property being sold constitutes an integral part of the Taxpayer's business operations.

Next, the background information provided by you states that the Taxpayer is in financial difficulty and as a result, Taxpayer will seek bankruptcy protection or a voluntary restructuring with its creditors. The sale at issue will be of substantially all of Taxpayer's domestic assets to a single buyer in connection with the restructuring. The consideration for this sale will be the payment of some cash with the balance in the form of the buyer's assumption of trade payables, employee benefit obligations, bank indebtedness, and other liabilities. Some of the cash proceeds may be required to maintain the foreign operations until a purchaser can be found. These facts indicate that in order for the business to continue operating, the sale is necessary. As a result, the sale of the property is essential to the business operations.

Based on the above, and according to the guidelines provided by the Illinois Supreme Court in Texaco-Cities, the gain arising from the sale at issue constitutes business income under Section 1501(a)(1) of the IITA. The recent Illinois Appellate Court case, Blessing/White, Inc. v. Zehnder, 329 Ill.App.3d 714, 768 N.E.2d 332, 263 Ill.Dec. 572 (1st Dist. 2002) does not apply in this situation. In Blessing/White the sale resulted in complete liquidation with the entire liquidation proceeds being distributed to shareholders. The Illinois Appellate Court held that because the liquidation proceeds were not used to support any ongoing business concerns, the gain on the sale was nonbusiness income. The facts in this case are distinguishable from the Blessing/White case in that the sale at issue will assist in the continuation of the foreign portion of the business. The remainder will be used to pay off claims of creditors against the business. None of the proceeds of any kind will be available for distribution to shareholders.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

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